DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 07-0047
Sales and Use Tax
For The Tax Period 2003-2005

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ISSUES

I. **Sales and Use Tax –** Manufacturing Exemption.

Authority: IC § 6-2.5-2-1(a); IC § 6-2.5-3-2(a); IC § 6-2.5-5-3(b); IC § 6-2.5-5-4; IC § 6-8.1-5-1(c); 45 IAC 2.2-5-8(c),(d),(f)(11); *Indiana Dep't of State Revenue v. Interstate Warehousing,* 783 N.E.2d 248 (Ind. 2003).

The Taxpayer protests the imposition of use tax on equipment and repair parts for the equipment.

II. **Sales and Use Tax –** Sales Tax Paid.

Authority: IC § 6-2.5-3-4(a)(1).

The Taxpayer protests the imposition of use tax where sales tax had already been paid.

III. **Tax Administration** - Ten Percent Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2(b)(c).

The Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

The Taxpayer is a corporation operating as a scrap metal recycler. Pursuant to an audit, the Indiana Department of Revenue (Department) assessed use tax, penalty, and interest against the Taxpayer. The Taxpayer protested a portion of the assessment and a hearing was held. This Letter of Findings results.

I. **Sales and Use Tax –** Manufacturing Exemption.

DISCUSSION

The Taxpayer purchased a grapple crane and repair parts, a magnet crane and repair parts, a baler and repair parts, and cutting torch and related supplies during the tax period. The Department assessed use tax on the Taxpayer's use of these items because they were not used in the production process. The Taxpayer considered the magnet crane and repair parts to be used in a taxable manner forty percent of the time and a non taxable manner sixty percent of the time. The Taxpayer had paid use tax on forty percent of value of the cranes and repair parts. The Taxpayer protested the use tax assessments on the remaining sixty percent of the value of the magnet crane and repair parts. The Taxpayer also protested the remaining assessments contending that the items qualified for a one hundred percent manufacturing exemption.

All tax assessments are presumed to be valid. IC § 6-8.1-5-1(c). The Taxpayer bears the burden of proving that any assessment is incorrect. *Id*.

IC § 6-2.5-2-1(a) imposes sales tax on retail transactions made in Indiana. A complementary use tax is imposed at IC § 6-2.5-3-2(a) on the use of tangible personal property that was purchased in an Indiana retail transaction without the payment of sales tax.

A number of exemptions are available from use tax. All exemptions must be strictly construed against the party claiming the exemption. *Indiana Dep't of State Revenue v. Interstate Warehousing,* 783 N.E.2d 248, 250 (Ind. 2003).

IC § 6-2.5-5-3(b) provides for the manufacturing exemption as follows:

> Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

Property purchased to repair machinery that is directly used in direct production is also exempted from the sales and use taxes pursuant to IC § 6-2.5.5-4.

The application of the manufacturing or "directly used in direct production" exemption is clarified at 45 IAC 2.2-5-8 as follows:

> (c) The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.
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> (d) **Pre-production and post-production activities.** "Direct use in the production process" begins at the point of the first operation or activity constituting part of the

> integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.
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> . . .

The Taxpayer receives shipments of its raw materials, assorted scrap metals and other items. First the piles of assorted scrap items are weighed and tested for radioactivity. Then cranes begin the sorting process. The cranes pick up items of similar metal types and place them in piles. This process is repeated with other items of similar metal types. As the cranes move the similar pieces of scrap metal to the pile, dirt and other contaminants fall off, thus beginning the cleaning process. This is evidenced by the Taxpayer's necessity of frequent sweeping of the sorting area. During this process unusable items are sorted out and rejected. Other machines use blow torches and shears to process the scrap metal into pieces that meet the size specifications of the purchasers. The baler then forms the processed scrap into bales as required by the purchasers' specifications. The magnet crane then moves the completed bales to storage before delivery to purchasers.

The Taxpayer's raw material consists of various types and sizes of scrap metal and its final product is baled metal of a similar type that has been cleaned, sized, and baled to meet the specifications of the Taxpayer's customers. The first step of the process of transforming the raw material to the final product is when the first crane picks up similar metal pieces and carries them across a distance for placement in a pile of pieces of similar metals. The determination that this is the first step in the production process is bolstered by 45 IAC 2.2-5-8(f) as follows:

> (11) A crane is used to move stockpiled materials to the next step of production for processing. Stockpiling allows moisture to drain and evaporate from washed stone, thereby reducing moisture levels to a standard generally acceptable to stone purchasers. The crane is exempt.

In this example, moving stone and allowing it to drain is considered processing. The Taxpayer's cranes move the metal allowing dirt and moisture to drain off so that the final product will meet the customers' requirements. The movement of the metal is an essential and integral production function that qualifies for the manufacturing exemption.

The final product consists of wrapped bales of sorted metals. The cranes do not merely pick up groupings of assorted metals from the truck and dump them on the ground to be sorted. Rather, the cranes perform the first sorting of the metals by segregating metals by type. This "first sorting" is a production function.

The shearers and blow torches cut and change the shape of the pieces of sorted and cleaned metals. These tools and their repair parts are integral and essential to the process of changing the shape of scrap metal to the final product as required by the Taxpayer's customers.

The baler shapes the pieces of sorted, cleaned, and sized metals into the shape required by the Taxpayer's customers. It also wraps a band around the processed and shaped metals. This is the wrapping that ends the production process.

After the production process is completed, the magnet crane and the grappler crane move the finished product to trucks for shipping to the Taxpayer's customers. The Taxpayer presented a study that indicated that these cranes are used forty percent of the time for this taxable purpose and sixty percent of the time for the exempt purposes listed above.

The Taxpayer presented sufficient evidence to sustain its burden of proving that it properly paid use tax on the forty percent taxable use of the grappler crane, magnet crane, and repair parts. The remaining sixty percent of the use of these cranes and repair parts qualify for the manufacturing exemption pursuant to IC § 6-2.5-5-3(b). The Taxpayer also presented sufficient evidence to sustain its burden of proving that the other items protested in this section qualified for the manufacturing exemption pursuant to IC § 6-2.5-5-3(b).

FINDING

The Taxpayer's protest is sustained.

II. Sales and Use Tax – Sales Tax Paid.

DISCUSSION

The Department assessed use tax on the Taxpayer's purchase of a surveillance camera, reference # 6819 on September 29, 2003, and materials to replace a truck line system, reference # 7974 on August 30, 2004. The Taxpayer protested the assessments. The Taxpayer argued that use tax was not due because the Taxpayer had paid sales tax at the time of purchase.

IC § 6-2.5-3-4(a)(1) provides an exemption from the use tax if the sales tax was paid on the transaction when the item was purchased. The Taxpayer provided invoices for the purchase of the surveillance camera and the materials for the replacement of the truck line system. The invoice for the purchase of the surveillance camera indicated that Taxpayer paid sales tax at the time of purchase. The invoice for the purchase of the materials indicated that the Taxpayer did not pay sales tax at the time of purchase.

FINDING

The Taxpayer's protest to the assessment of use tax on the surveillance camera is sustained. The Taxpayer's protest to the assessment of use tax on the materials for the trunk line is respectfully denied.

III. Tax Administration - Ten Percent Negligence Penalty.

DISCUSSION

The Taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
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> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The Taxpayer provided substantial documentation to indicate that its failure to pay the assessed use tax was due to reasonable cause rather than negligence.

FINDING

The Taxpayer's protest to the imposition of the penalty is sustained.